

Revenue Review

Tennessee Department of Revenue

www.Tennessee.gov/revenue

REVENUE ...
Working For You



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Contents:

Recent Court Developments...1

Hall Income Tax.....2

Sales and Use Tax Return Change.....3

New Credit-Card Payment Option for Use Tax.....3

Excise Tax and Franchise Tax Computation for REITs.....3

Update on 338(h)(10)3

Upcoming Workshops4

Contact Info4

Did You Know...

You can receive notices and other publications instantly by signing up on one of the department's ListServes? Visit our Web site to subscribe to Revenue-News or lists dedicated to county clerks and city officials.

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Streamlined Sales Tax Update

Approximately 64% of Tennessee's total tax collections are derived from the sales and use tax. It is estimated that Tennessee has lost and will continue to lose significant revenue as a result of the growth in electronic commerce and other remote sales activity. In the July 2004 report "State and Local Sales Tax Revenue Losses from E-Commerce," Dr. Donald Bruce and Dr. William F. Fox update two previous University of Tennessee studies in which they examined the effects of e-commerce on state and local government revenues. By 2008, revenue loss estimates for state and local governments range between \$21.5 billion and \$33.7 billion, with the greatest losses occurring in states that rely most heavily on the sales tax as a revenue source. By 2008, Tennessee's state and local combined losses are projected to reach between \$612.5 million and \$957.9 million.

Because of the complex sales tax laws that exist across the country, a seller who does not have some physical presence in a state is not required to collect that state's sales tax. While the consumer who buys an item without paying sales tax is required to pay "use tax" on the purchase, many consumers do not pay what they owe. It is administratively very difficult for a tax agency to efficiently enforce the payment of the use tax.

For more than six years, Tennessee has participated in a multi-state effort to make sales tax laws across the country simpler and more uniform. The goal of the Streamlined Sales Tax effort is to reduce the complexity of sales tax collection so that sellers collect sales tax for all the states within which they make sales. This would create a level playing field for local merchants who have always been required to collect their state's taxes. This would also allow the state to efficiently collect the taxes which are currently owed under the state's laws.

The Streamlined Sales and Use Tax Agreement (SSUTA) sets forth the uniformity and simplification requirements that a state must have in its laws in order to be a member of the Streamlined Sales and Use Tax Governing Board, Inc. (Governing Board). Tennessee's law changes are scheduled to take effect on July 1, 2007. Because Tennessee's law changes are not yet effective, Tennessee is an associate member of the Governing Board.

The Governing Board was organized on Oct. 1, 2005, with 13 full-member states and six associate-member

states. On Jan. 1, 2007, Vermont and Rhode Island will join as new full-member states. Full-member states have changed all of their laws to conform to the SSUTA.

The Oct. 1, 2005, kickoff launched a broad-based amnesty program (See October 2005 *Revenue Review*) for sellers that registered through the Streamlined Central Registration System: www.sstregister.org/sellers. To receive amnesty, sellers were required to collect tax in all full-member states, and had the option to agree to collect in associate-member states.

As of Nov. 1, more than 1,100 sellers registered through the Central Registration System. Approximately one-half of those agreed to collect Tennessee's tax at the time of their registration. When Tennessee's Streamlined legislation takes effect and it becomes a full-member state, all sellers that registered through the Streamlined system will be required to collect Tennessee's sales tax.

The Governing Board has also certified three companies as "certified service providers" that provide sales tax collection and remittance services for sellers. These companies are Taxware, Avalara and Exactor.

Chapter 311, Public Acts of 2005 requires Tennessee's delegates to the Governing Board to prepare a report due Dec. 31, 2006, that addresses the effects of the Tennessee law changes on local governments and small businesses. This report will be available on the department's Web site.

There is significant information about the Streamlined effort available at www.Tennessee.gov/revenue as well as the Streamlined Web site at www.streamlinedsalestax.org. Please check the department's Web site periodically for updates on the Streamlined effort.

Recent Court Developments

Tennessee has won an important case concerning the issue of nexus for sales and use tax purposes. "Nexus" is the factor that determines whether an out-of-state business selling products into Tennessee is required to collect tax on sales in Tennessee. Nexus for sales tax purposes is established by having some presence in the state such as a business presence, ownership of real or personal property, leasing activities, having employees in the state, etc. The activities of a third party may also create nexus liable for collecting the tax on sales in Tennessee. As set forth in the Streamlined Sales Tax discussion, it is important to the

Continued on page 2, see Recent Court Developments.

Recent Court Developments, cont.

preservation of Tennessee's sales tax base to have sellers collect tax that is legally due.

Arco Building Supply, Inc., an out-of-state retailer with its offices in Georgia, is in the business of selling single-story metal buildings. Arco did not have property or employees in Tennessee. During the audit period at issue, it acquired the metal buildings from four manufacturers. All of the manufacturers were registered Tennessee dealers, and one was physically located in Tennessee. Typically, a sale was initiated when a customer placed a telephone call to Arco's office in Georgia. An Arco employee ascertained the customer's needs and then contacted its manufacturers to determine which one could engineer, manufacture, and ship the building to the customer. The manufacturer then constructed the building and notified Arco when it was ready. Arco notified the customer that its building was ready, but the manufacturer actually shipped the building directly to the customer. Upon delivery of the building, the customer gave a cashier's check made out to Arco to the common carrier. The carrier then delivered this check to the manufacturer. The manufacturer had power-of-attorney to cash the check and retained from these funds the amount Arco owed it for constructing the building.

Under these facts, Arco's registered manufacturers would be required to collect Tennessee sales tax on the sales they ship to Tennessee customers unless they received a valid Tennessee resale certificate from Arco. (Tenn. Admin. R. & Comp. R. 1320-5-1-.96). Arco, therefore, registered as a Tennessee dealer so that it could issue its manufacturers a resale certificate, thereby exempting them from the obligation to collect and remit Tennessee sales and use taxes. Arco then failed to collect and remit taxes on the sales to Tennessee customers, claiming that it had no nexus.

The Tennessee Court of Appeals concluded that Arco had sufficient Tennessee presence through its connections with a Tennessee manufacturer to create nexus and sustain the tax assessment. The activities occurring in Tennessee included the engineering and manufacturing of the buildings, shipping via intrastate common carrier, and acceptance of customers' payments. The Court reiterated, citing earlier court decisions, that "a substantial nexus may be established by the activities carried on within the state by affiliates and independent contractors" acting on the taxpayer's behalf.


The Court cited as an additional basis for its holding, Arco's "deliberate manipulation" of Tennessee's tax laws. It stated that Arco took steps in Tennessee to set up a "double exemption" from Tennessee sales and use tax. It concluded that "nothing in the Court's case law suggests that the dormant Commerce Clause should be interpreted to strip states of the power to protect themselves and their tax bases from such deliberate manipulation in the name of protecting the national economy."

The Tennessee Supreme Court has elected not to review this decision. Consequently, the opinion of the Court of Appeals is final. **Arco Building Systems, Inc. v. Chumley**, 2006 WL 1627284 (Tenn. Ct. App.)

Individual (Hall) Income Tax

Did you know ...
Tennessee
has a tax
on Bonds
and Dividends
on Stock?



 Due April 15

6% levy and generally applies annually to income from investments such as stocks and bonds, but not to basic savings accounts, CDs, and employer-sponsored retirement accounts.

Most Tennesseans know that Tennessee does not impose a tax on general income from sources such as wages, salaries, and Social Security and pension income. However, Tennessee does have a form of income tax. Enacted in 1929, the Hall income tax (named after the legislative sponsor) is one of the oldest taxes in Tennessee. It is a

The tax applies to individuals, partnerships, associations, and trusts that are legally domiciled in Tennessee. A person legally domiciled in another state but maintaining a place of residence in Tennessee for more than six months of the year is also subject to the tax. This does not apply to military personnel and full-time students who are legally domiciled in another state. The income a person receives while legally domiciled in Tennessee is subject to the tax.

The first \$1,250 of taxable income is exempt (\$2,500 on a joint return). Individuals 65 years old or older with total annual income of \$16,200 or less (\$27,000 for joint filers) are exempt from this tax. Blind persons may be exempt upon filing a statement from their eye specialist. Only those people whose legal domicile is in Tennessee and whose taxable interest and/or dividend income exceed \$1,250 (\$2,500 for joint filers) are required to file.

The Department of Revenue offers electronic filing of the individual income tax. Taxpayers also may file paper returns.

Income Tax Extension Payments

The Department of Revenue reminds individual income taxpayers to remember, upon filing their individual income tax return, to take credit on Line 5 (front of return) for prepayments. An unusual number of taxpayers fail to do so each filing year creating unnecessary refunds. These prepayments are usually made in conjunction with applications to extend the filing date by means of filing form INC 251 – Application for Extension of Time to File Individual Income Return.

Taxpayers are also reminded that income tax filers do not need to file form (INC 251) separate from their tax return. An automatic six-month extension of time will apply if the taxpayer attaches a written request to his or her tax return filed on or before the extended due date of the return. Taxpayers may use either an extension form from the Department of Revenue (INC 251) or the taxpayer's federal request for extension filed for the corresponding tax period.


Interest will accrue on the unpaid amount from the original due date of the return until the tax is paid. Penalty will not apply if the return is filed and the amount due is paid on or before the extended due date and the return includes the request for extension.

Important Reminder: RETAILERS MUST REPORT EXEMPT HOLIDAY SALES ON SALES TAX RETURN

The Sales and Use Tax Return was revised to accommodate Tennessee's first annual sales tax holiday. Retailers selling items exempt from tax during the holiday WERE REQUIRED to report their exempt sales on Schedule A, Line J of their sales and use tax return. **All other items previously reported on Schedule A, Line J should have been reported on Schedule A, Line C.**

For the August 2006 period, some retailers incorrectly completed the new schedule A and reported sales tax holiday sales on lines other than J or reported sales on line J that were not exempt for the sales tax holiday. Retailers were contacted by the department to seek amended returns or to correct filed returns.

Please note the language for the revised **exempt transaction** schedule A, line J:

- J.  Sales Tax Holiday (Aug. 3-5, 2007, and April 27-29, 2007)

If you have any questions about the change in the Sales and Use Tax Return, please contact the Revenue Call Center. Tennessee residents outside the Nashville calling area may call our statewide toll-free number at (800) 342-1003. Callers from Nashville or out-of-state may call (615) 253-0600. You can also access additional information on our Web site at www.Tennessee.gov/revenue.

Revenue Adds Credit-Card Payment Option for Consumer Use Tax

The Department of Revenue now accepts credit cards for payment of consumer use tax. Consumers can take advantage of filing electronically and paying by credit card on Revenue's Web site, www.Tennessee.gov/revenue. The department accepts the following credit cards: MasterCard, American Express and Discover Card. There is an associated 2.49% processing fee.

This is the third credit-card payment Revenue has launched for customers. The Department of Revenue reminds online shoppers, mail-order customers, and out-of-state bargain hunters to e-file their consumer use tax, the counterpart to the state's sales tax.

Revenue Issues Notices Concerning Excise Tax and Franchise Tax Computation for REITs

Effective July 1, 2006, Public Chapter 1019 amended Tenn. Code Ann. Section 67-4-2006 relative to the excise tax computation such that a deduction now only exists for persons treated as partnerships for federal tax purposes who distribute all or a portion of its net earnings or net losses to a publicly traded real estate investment trust (Public REIT). This Public Chapter also amended Tenn. Code Ann. Sections 67-4-2105 and 67-4-2108 franchise tax computation for persons treated as partnerships for federal tax purposes and who are owned, directly or indirectly, by a real estate investment trust (REIT). Please

refer to the department's Web site for notices that provide instruction for tax base and estimated payment calculation for these laws that took effect July 1, 2006.

Update on 338(h)(10)

The department has received a number of inquiries regarding the 26 USC § 338(h)(10) election and its effect on a taxpayer's franchise and excise tax liability. The 338(h)(10) election is made when the stock in a target company is sold to a buyer company. Normally, a stock sale would result in gain or loss to the shareholders of the target company. By making the 338(h)(10) election, the parties to the transaction elect to have the stock sale treated as a deemed sale of the target company's assets to the buyer company. As a result of the election, the target company recognizes gain to the extent the allocated purchase price exceeds the target's adjusted tax basis in its assets (or a loss if the target's basis exceeds the purchase price). The target company's shareholders recognize no gain or loss on the sale. The buyer company receives a stepped-up basis in the target's assets, to the extent of the allocated purchase price. The buyer company also treats the acquired assets as new assets for depreciation purposes.

Tennessee neither recognizes nor disallows the 338(h)(10) election. Rather, the taxpayer must calculate its Tennessee taxable income beginning with federal taxable income. Because the target company's federal taxable income includes the gain or loss from the deemed asset sale, its Tennessee taxable income will also reflect the gain or loss. For the same reason, the Tennessee taxable income of the target company's shareholders will not include any gain or loss from the underlying stock sale. The party that includes the gain in its income will also include the gain in the receipts factor of its apportionment formula. It is important to note that if the target company is an S corporation, the target's Tennessee taxable income will not include any gain or loss from the deemed asset sale. This is because an S corporation must compute its federal taxable income for Tennessee tax purposes as though it were a C corporation. As a C corporation, the taxpayer would not qualify for the 338(h)(10) election, and its federal taxable income will therefore not include any gain or loss that is attributable to the election. The buyer entity is not affected.

Frequently Asked Sales/Use Tax Question

Q: What is the correct treatment for capital leases for sales and use tax?

Pursuant to Tenn. Code Ann. Section 67-6-204, sales or use tax is imposed on the gross proceeds of all leases and rentals of tangible personal property in this state where the lease or rental is a part of the regularly established business. Tennessee's sales and use tax statutes do not reference GAAP or federal law and make no distinction between types of leases.

According to Rule 1320-5-1-.32, sales tax is assessed for leases on a billing basis whether it is all collected at the time of the execution of the lease or collected with each payment. The tax may be based on either the lump sum payment at the time of execution of the contract, or on a monthly or periodic basis if the contract provides for monthly or periodic payments. In either case, the sales tax should be assessed in accordance with the lease payment plan.

Requirements Concerning "Delivery Sales" of Cigarettes in Tennessee

Chapter 388 of the Public Acts of 2005 (Tenn. Code Ann. Section 67-4-1029) imposes additional labeling and reporting requirements on any person selling cigarettes by means of "delivery sales" to consumers in Tennessee. Delivery sales include any sale made by taking an order by telephone, mail, the Internet, or other online service. Delivery sales also include any sale made by delivering cigarettes directly to consumers in Tennessee through the mail or other delivery service.

Any seller, dealer, or distributor making delivery sales must provide a prominent and clearly legible statement on its Web site or in other literature to each prospective consumer that:

1. Cigarette sales to consumers below the legal minimum age are illegal;
2. Sales of cigarettes are restricted to those who provide proof of age; and
3. Cigarettes are subject to cigarette tax (along with an explanation of how such tax has been paid or will be paid).

Any person making delivery sales must also include the following as a clear and conspicuous statement on the package: "Cigarettes: Tennessee Law Prohibits Shipping to Individuals Under Age Eighteen, and requires the payment of all Applicable Taxes." Additionally, the seller must use a method of delivery that obligates the delivery service to restrict delivery to an adult of legal age and to require the consumer who placed the order or another adult of legal age to accept delivery with a signature.

Any person making delivery sales must report the following information to the Department of Revenue by the 10th day of the month following the sale:

1. The name and address of the consumer to whom any delivery sale was made;
2. The brand or brands of cigarettes that were delivered; and
3. The quantity of cigarettes delivered.

A seller, dealer, or distributor of cigarettes who commits a first violation of these requirements is subject to a fine of \$1,000 or five times the retail value of the cigarettes involved, whichever is greater. A second or subsequent violation subjects the seller to a fine of \$5,000 or five times the retail value of the cigarettes involved, whichever is greater. A delivery service that fails to comply with its obligations is subject to a fine of \$500.

Cigarettes sold to a Tennessee consumer by delivery sale are subject to the same cigarette tax as they would be if purchased in a store. If a Tennessee tax stamp is not affixed to the pack of cigarettes, the Tennessee cigarette tax has not been paid. The Tennessee tax is due even if the cigarettes have the stamp of another state. The current Tennessee cigarette tax is 20 cents per pack of 20 cigarettes or \$2 for a standard carton containing 10 packs. The seller, dealer, or distributor making the delivery sale is required to collect and remit the Tennessee cigarette tax on any cigarettes without a Tennessee stamp.

If Tennessee sales tax is charged by the seller, as reflected on the invoice or receipt, then the purchaser does not owe use tax on the sale. However, if a purchaser in Tennessee buys any taxable merchandise (including cigarettes) and sales tax is not charged by the seller, then the purchaser is responsible for paying use tax directly to the Department of Revenue.

Save the Date: New Business Workshops (NBW) Across the State

January

Jan. 10 – NBW, Chattanooga, 8:30 a.m. – 1:15 p.m.

Jan. 10 – NBW, Knoxville, 8:30 a.m. – 12:30 p.m.

Jan. 11 – NBW, Memphis, 9 a.m. – Noon

Jan. 11 – NBW, Johnson City, 8:30 a.m. – 11:45 a.m.

Jan. 23 – NBW, Nashville, 9 a.m. – 12:45 p.m.

March

March 8 – NBW, Memphis, 9 a.m. – Noon

March 8 – NBW, Johnson City, 8:30 a.m. – 11:45 a.m.

March 14 – NBW, Chattanooga, 8:30 a.m. – 1:15 p.m.

March 14 – NBW, Knoxville, 8:30 a.m. – 12:30 p.m.

March 20 – NBW, Nashville, 9 a.m. – 12:45 p.m.

Contact Us

- Taxpayer Services hot line: Statewide toll-free (800) 342-1003; Nashville-area and out-of-state callers should call (615) 253-0600.
- Vehicle Services hot line: Statewide toll-free (888) 871-3171; Nashville-area and out-of-state callers should call (615) 741-3101.
- Online tax help by e-mailing TN.Revenue@state.tn.us.
- Streamlined Sales Tax hot line: In Tennessee, call (877) 250-2299. In Nashville and outside Tennessee, call (615) 253-0752.
- Streamlined Sales Tax online assistance by e-mailing Streamlined.Salestax.QandA@state.tn.us.
- Tax practitioner hot line: Statewide toll-free (800) 387-8395; Nashville-area and out-of-state callers should call (615) 253-0700.
- Local government hot line: (866) 562-2549.
- E-mail updates: Visit our Web site, www.Tennessee.gov/revenue, to subscribe.
- Electronic commerce hot line: Statewide toll-free: (866) 368-6374. Nashville-area and out-of-state callers should dial (615) 253-0704.
- Speakers bureau: (615) 532-4975.
- Tax fraud hot line: To report tax fraud, call (800) FRAUDTX (372-8389).

Are you a registered taxpayer? If YES, we need your tax contact's e-mail address, so we can e-mail information in the future. Call toll-free (800) 342-1003; Nashville-area and out-of-state callers, dial (615) 253-0600.



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